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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF
THE COMMONWEALTH OF KENTUCKY, et al.,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI TO THE
KENTUCKY COURT OF APPEALS

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QUESTION PRESENTED

Whether Kentucky's income tax scheme violates the Commerce Clause of the United States Constitution in its negative, or dormant, aspect by exempting from taxation interest income on bonds issued by Kentucky and its local governmental subdivisions while taxing interest income on bonds issued by other States and local governmental subdivisions.

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PRELIMINARY STATEMENT

This is a tax case in which Kentucky is using its tax power to discriminate against the interstate trade of out-of-state municipal bonds. Specifically, Kentucky taxes the income its citizens earn from out-of-state municipal bonds while exempting from taxation the income its citizens earn from in-state municipal bonds. The intended effect is to encourage Kentucky citizens to purchase in-state municipal bonds by discouraging their purchase of out-of-state municipal bonds. As a result, out-of-state issuers and sellers encounter a barrier to the sale of out-of-state municipal bonds in Kentucky. In the decision below, the Kentucky Court of Appeals held that this facially discriminatory tax scheme violates the dormant Commerce Clause. This conclusion is correct and the Court should affirm.

"A State's power to lay and collect taxes, comprehensive and necessary as that power is, cannot be exerted in a way which involves a discrimination against interstate commerce." *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 574-75 (1997) (citation and alteration omitted). Thus, a State may not use its tax power to erect barriers to interstate commerce that discriminate in favor of in-state economic interests by burdening out-of-state economic interests. *E.g.*, *New Energy Co. v. Limbach*, 486 U.S. 269 (1988). Yet, Kentucky's tax scheme does just that: It purposefully promotes the purchase of in-state municipal bonds in Kentucky by erecting a barrier to the purchase of the same out-of-state commodity.

Laws that discriminate against interstate commerce in this way are subject to "a virtually *per se* rule of invalidity." *Granholm v. Heald*, 544 U.S. 460, 476 (2005) (internal quotation marks and citation omitted). Invalidation is especially warranted here because Kentucky's law operates as a tariff; *i.e.*, a law that "taxes goods imported from other States, but does not tax similar products produced in state," *West Lynn*

Creamery, Inc. v. Healy, 512 U.S. 186, 193 (1994). Kentucky seeks to evade invalidation by citing its role as an issuer of bonds and what it does with the proceeds. But what is challenged here is not Kentucky's issuance of in-state municipal bonds, but its discriminatory taxation of out-of-state municipal bonds. The Court's precedents teach that, in tax cases like this one, the analysis focuses on the impact of the discriminatory tax on the municipal bond market. The issue is not the benefits Kentucky secures with its bond scheme, but rather the burdens it imposes with its tax scheme.

Kentucky makes no serious effort to argue that its tax scheme is valid if recognized as what it is—a facially discriminatory tax regime. Instead, it seeks refuge in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007). But Kentucky's argument ignores the vastly different circumstances of that case that led the Court to find a lack of discrimination. In *United Haulers*, the Court reviewed a flow control ordinance that was part of a State's plan to take over a local waste-handling market within a specific geographic area. The Court emphasized that the favored waste facility was publicly owned, that no out-of-state commodity faced a barrier blocking access to a private market, and that the harm caused by the ordinance was likely to fall on the very people who had voted for it. In contrast, Kentucky's scheme taxes municipal bonds that are not under Kentucky's exclusive control, blocks the access of other issuers and sellers to the private bond market, and the harm caused by the law falls largely on those who cannot vote in Kentucky.

Kentucky's other arguments as to why its tax scheme is non-discriminatory are without merit. Kentucky contends that its scheme is not discriminatory on the theory that it is not similar to other States, and its municipal bonds are not similar to other municipal bonds. It claims this special status

because only Kentucky can raise revenue for Kentucky. But every State raises revenue only for itself, and this contention demonstrates not that Kentucky is different from all other States, but that it is like all other States. So too, Kentucky's municipal bonds are exactly like those issued by other States: all are rated by the same agencies, regulated by the same federal law, compete for the same capital, and are traded by the same participants in the same national market. That Kentucky introduces bonds into the national market for a public purpose does not authorize Kentucky to use its tax power to discourage the private trade of out-of-state municipal bonds in the same market. *Everything* a State does is for a public purpose. If Kentucky can justify its tax on the ground that it serves a public purpose, any State could justify any discriminatory tax for the same reason. As the Court has explained, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste Sys., Inc. v. Department of Envtl. Qual.*, 511 U.S. 93, 100 (1994).

Kentucky's attempt to invoke the Court's market participation doctrine also fails. As the Court has concluded, "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market participation doctrine." *Camps*, 520 U.S. at 593. Private actors do not have the power to tax, and the doctrine's rationale—to allow the State the rights of private parties—does not apply.

Kentucky's tax scheme frustrates the purposes of the Commerce Clause by promoting economic balkanization, hoarding a local resource, and exporting the costs of its tax by burdening out-of-state issuers and sellers who cannot vote in Kentucky. The scheme also harms Kentucky's interests because the purported benefit to Kentucky (*i.e.*, a reduction in its borrowing costs for municipal bonds owing to the tax-free status for its residents) is more than wiped out by its loss of tax revenues. Kentucky enacted its discriminatory tax law

because other States enacted similar laws and Kentucky is compelled to follow suit to protect its interests. The cure for this "race to the bottom" is to enforce the Court's dormant Commerce Clause precedents and affirm the decision below.

STATEMENT

A. The Respondents

Respondents George W. Davis and Catherine V. Davis are Kentucky citizens who hold (through mutual funds) a modest but diversified portfolio of municipal bonds issued by a number of States. Because of this diversification, their fortunes do not depend on the financial success or failure of a single municipal bond issue or issuer. Kentucky's tax regime penalizes the Davises for their participation in interstate commerce by taxing the income they (and other Kentucky citizens) earn on out-of-state bonds, while not taxing the income that they (and other Kentucky citizens) earn on municipal bonds issued by Kentucky and its subdivisions.

B. Municipal Bonds

Municipal bonds are debt instruments representing a contractual promise by the governmental issuer to repay the investor the principal amount of the bond with interest. They generally are of the following types: (1) "general obligation bonds," backed by the full faith, credit, and tax power of the issuing State; (2) "moral obligation bonds," not backed by the full, faith, credit, and taxing power of the State; and (3) "revenue bonds," issued to fund publicly owned infrastructure projects such as roads and schools, and backed by a pledge of the revenue generated from a specific project. J. W. Temel, THE FUNDAMENTALS OF MUNICIPAL BONDS 55-56, 58 (5th ed. 2001). "Industrial revenue bonds" (including those designated for federal tax purposes as "private activity bonds," *see* 26 U.S.C. § 141) are municipal bonds used to develop commercial or industrial property for the benefit of

private corporations and are backed by revenue from that private project or secured by property used in private business. K. Thomas Liaw & Ronald L. Moy, THE IRWIN GUIDE TO STOCKS, BONDS, FUTURES, AND OPTIONS: A COMPREHENSIVE GUIDE TO WALL STREET'S MARKETS 194 (2001).

Kentucky classifies its bonds as either "appropriation supported debt," or "non-appropriation or moral obligation debt." General obligation bonds would fall in the first category, but Kentucky has none outstanding. Instead, Kentucky issues only project revenue bonds (some of which are supported by biennial legislative appropriations), and industrial revenue bonds (which generally are not). Pet. Br. 7-8. As of June 30, 2006, $7.9 billion of the approximately $33.8 billion in Kentucky bonds are industrial revenue bonds. *Id.* at 7. Thus, roughly 23% of Kentucky's outstanding municipal bonds finance private businesses in Kentucky.

Municipal bonds are rated by independent agencies and traded in interstate commerce as financial commodities with generally standard terms. When a State (or subdivision) issues a municipal bond, it usually does not deal directly with the investing public but with intermediary underwriters. Frank J. Fabozzi, BOND MARKETS, ANALYSIS, AND STRATEGIES 189 (5th ed. 2004). Municipal bond issuers either negotiate price terms directly with underwriters or award a bond issue through a competitive process in which underwriting syndicates (temporary partnerships of bond dealers acting together) submit bids. The syndicate with the highest bid is awarded the issue. *Id.*; *see* Robert Zipf, HOW THE BOND MARKET WORKS 99 (2d ed. 1997). Once purchased, the bonds are sold to dealers or to individuals, insurance companies, commercial banks, bond mutual funds, or investment trusts. *Id.* at 106, 110. After their initial issuance and sale, the bonds are traded in the national municipal bond market. The private Bond Market Association disseminates prices for

actively traded municipal bonds and Standard & Poor's publishes a daily list of municipal bonds offered for sale in the market by over 700 broker-dealers (between 7,000 and 8,000 bonds with a par value of $1.4 billion). Temel at 105.[1]

The market ordinarily would "price" a municipal bond issue based purely on relative quality as measured in part by the rating of an independent agency. A State can distort the market-pricing function by its tax system, as Kentucky does through its tax scheme. Kentucky citizens are willing to accept less interest on Kentucky bonds because they pay no state income tax on their earnings. Because the interest on out-of-state bonds is taxed, the effective yield on these bonds is much less when the tax is taken into account. *See* Jason Van Bergen, *Weighing the Tax Benefits of Municipal Securities*, Investopedia.com, July 28, 2004, *available at* http://www.investopedia.com/articles/04/072804.asp (showing increase in equivalent taxable yield).

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[1] *See* Respondents' Supplemental Appendix ("RSA") 18a (filed herewith) (examples of Kentucky and Alabama bonds). By 1999, ninety percent of newly issued municipal bonds were issued in book-entry form. Issuers deposit a single certificate for each bond at a central clearing house, usually the Depository Trust Company Corporation ("DTC"). The investor does not receive a bond certificate; all ownership and transactional records are kept electronically. Temel at 46-47. Prospective bond purchasers are usually provided with an Official Statement (a disclosure document produced by the issuer). The document provides legal and financial information that the prospective investor may use to make an informed decision regarding investment in a new bond issue. The statement's cover page summarizes information on the bond's rating, maturity date, date of issuance, interest rate, and price. Zipf HOW THE BOND MARKET WORKS at 112; *see* RSA 21a (Cover Pages of Examples of Kentucky and Minnesota Official Statements).

C. The Challenged Tax Scheme

Kentucky's discriminatory tax scheme is described in its brief. Pet. Br. 2-3. It is undisputed that the scheme treats interest from in-state and out-of-state bonds held by Kentucky taxpayers in a facially disparate manner, by taxing interest on out-of-state municipal bonds while exempting from taxation interest on in-state municipal bonds. Kentucky is not alone in this practice; history demonstrates its gradual spread among the States as each responded to the other's discriminatory law by enacting its own.

Congress has excluded municipal bond interest from gross income subject to federal income tax beginning with the first federal income tax statute. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. In 1919, New York enacted a statutory scheme that exempted from its income tax the interest earned on municipal bonds issued by New York, but denied this benefit to interest earned on bonds issued by other States. GFOA Br. 5 (1919 N.Y. Laws 1641–42). Other States soon began adopting similar measures: North Carolina in 1921, *id.* (1921 N.C. Sess. Laws 207-208); Virginia in 1926, *id.* (1926 Va. Acts 961); and Kentucky in 1936, *see Reynolds Metal Co. v. Martin*, 107 S.W.2d 251, 254 (Ky. 1937). This "race to the bottom" led to widespread retaliation, with 43 States offering some form of tax preference for interest earned on in-state municipal bonds. *See* RSA 1a; Brian Galle & Ethan Yale, *Municipal Bonds and the Dormant Commerce Clause After* United Haulers, 115 TAX NOTES 1037, 1038 (2007).

D. The Decision Below

In April 2003, the Davises filed a class action challenging Kentucky's municipal bond taxation scheme under the dormant Commerce Clause and the Fourteenth Amendment Equal Protection Clause. In July 2003, before a class had been certified, Kentucky moved for summary judgment, arguing that its scheme is constitutional. The trial court

granted the motion, relying on the market participant doctrine in ruling that the scheme does not violate the dormant Commerce Clause. "When a state issues municipal bonds," the court concluded, "it participates in the bond market by supplying bonds in the market and paying interest on those bonds." Pet. App. A18. Thus, the court held, Kentucky "may pay a higher rate of interest to resident purchasers based upon theories of distributing state created benefits and market participation." *Id.* The Davises appealed. In the decision below, the Kentucky Court of Appeals vacated the trial court's order, holding that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id.* A6. Kentucky filed a motion for discretionary review with the Kentucky Supreme Court, which was denied on August 17, 2006. *Id.* A14.

SUMMARY OF ARGUMENT

Kentucky's discriminatory tax scheme violates the dormant Commerce Clause. It taxes the income Kentucky taxpayers earn on out-of-state municipal bonds, while exempting from taxation the income they earn on in-state municipal bonds, thus discriminating on its face against out-of-state bonds by discouraging their purchase. In every substantive respect, Kentucky's law operates as a tariff by "tax[ing] goods imported from other States, but [not taxing] similar products produced in State." *West Lynn*, 512 U.S. at 193. Like any tariff, Kentucky's tax scheme is motivated by economic protectionism and promotes local economic interests over out-of-state interests. Like any tariff, Kentucky's scheme violates the purposes behind the dormant Commerce Clause. It fosters economic balkanization and retaliation, as almost every State has felt compelled to enact the same discriminatory tax law to encourage the sale of its own bonds by discouraging the purchase of other States' bonds. It hoards a

local resource by blocking access to local investment dollars. And it is undemocratic because it burdens out-of-state issuers and sellers who cannot vote in Kentucky elections. In case after case, the Court has struck down every discriminatory tax of this kind and should do so here.

Kentucky's reliance on *United Haulers* in support of its scheme is misplaced. There, the State authorized the public acquisition of the waste-handling market in a defined geographic area to remedy local environmental, health, and safety concerns. A local flow control ordinance directing local use of the public facility supported operation of the public-market facility. The ordinance was not a tax (let alone a facially discriminatory tax) and it did not exclude out-of-state waste from the facility; it simply directed local use of the local public market. In this case, Kentucky's facially discriminatory tax scheme does not support the operation of a local, publicly owned market. Rather, it operates as a tariff by burdening and exploiting the privately owned national municipal bond market, inflicting at least five distinct harms on interstate commerce. First, it harms out-of-state issuers (*i.e.*, other States and their subdivisions) by blocking their access to investment dollars in Kentucky. Second, it similarly harms out-of-state private sellers (*e.g.*, underwriters, individuals, and investment funds) who wish to sell their bonds in Kentucky. Third, it harms the national municipal bond market and its participants by distorting and impeding the free flow of capital. Fourth, it harms Kentucky investors by promoting risky, high-cost investment vehicles. Fifth, it harms the States by compelling them to enact competing discriminatory laws that decrease their net revenues. These features condemn Kentucky's law and demonstrate that it is fundamentally different from the ordinance at stake in *United Haulers*.

Kentucky's reliance on the market participant doctrine to save its tax scheme is also misplaced. As the Court's prece-

dents demonstrate, the doctrine does not apply to discriminatory tax schemes. Nor should it. The doctrine's purpose is to allow States to enjoy the same rights as private parties in their commercial dealings. But private parties have no right to manipulate the market through discriminatory taxes, and Kentucky cannot avail itself of the doctrine here.

Kentucky's arguments based on sovereign prerogatives and local autonomy fare no better. The question is not whether Kentucky is a sovereign, or whether it may issue municipal bonds for public purposes, or the like. Rather, the question is whether Kentucky may enact a discriminatory tax that discourages the trade of out-of-state municipal bonds in the national municipal bond market. Kentucky's theory is that, as a sovereign issuer operating for public purposes, it may do as it pleases. That is not and cannot be the law. If it were, there would be nothing left to the Court's discriminatory tax precedents—indeed, the dormant Commerce Clause itself—as the same argument could justify any tariff so long as the State argued it promoted a public purpose. Kentucky's theory is wrong and should be rejected.

Kentucky's arguments concerning congressional inaction, claimed reliance interests, and any financial burden that allegedly would result from an affirmance are meritless and provide no basis for reversal. The States have long known that their discriminatory tax schemes are problematic under the dormant Commerce Clause. Moreover, should the Court affirm, the market will adjust quickly without the dire consequences Kentucky predicts. More importantly, it will function as the free national market the Framers envisioned.

Kentucky's scheme also violates another constitutional restriction that supports the Court's dormant Commerce Clause precedents in the tax context. Specifically, Kentucky's discriminatory tax scheme imposes an impermissible duty on out-of-state financial commodities in violation of the

Import-Export Clause. For each of these reasons, the Court should affirm the decision below.

ARGUMENT

A. Kentucky's Tax Scheme Violates the Dormant Commerce Clause.

The Court has long recognized that the Commerce Clause in its "negative" or "dormant" aspect limits the States' power to regulate interstate commerce "even in the absence of a conflicting federal statute." *United Haulers*, 127 S. Ct. at 1792-93 (citations omitted). "Time and again" the Court has reiterated that, "in all but the narrowest circumstances," state laws violate the dormant Commerce Clause if they "mandate differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Granholm*, 544 U.S. at 472 (internal quotation marks and citation omitted). "This rule is essential to the foundations of the Union," and "reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Id.* (internal quotation marks and citation omitted); *see Camps*, 520 U.S. at 595 ("even the smallest scale discrimination can interfere with the project of our Federal Union").

The rule aims to promote free trade and prevent the hoarding of local resources. *C&A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 392 (1994). It reflects the policy that the "States should not be compelled to negotiate with each other regarding favored or disfavored status for their own citizens" and prevents "[r]ivalries among the States" and "a proliferation of trade zones." *Granholm*, 544 U.S. at 472-73 (citation omitted). It also promotes a critical underpinning of our democracy; that of placing the costs of government regu-

lations on those who are able to vote for or against them. *United Haulers*, 127 S. Ct. at 1797 ("Our dormant Commerce Clause cases often find discrimination when a State shifts the costs of regulation to other States, because when the burden of state regulation falls on interests outside the state, it is unlikely to be alleviated by the operation of those political restraints normally exerted when interests within the state are affected.") (internal quotation marks and citation omitted).

A State's use of its tax power to attain a superior position in the national financial markets is antithetical to these principles. *Gibbons v. Ogden*, 22 U.S (9 Wheat.) 1, 231 (1824) ("If there was any one object riding over every other in the adoption of the constitution, it was to keep commercial intercourse among the States free from all invidious and partial restraints."). Indeed, a central purpose of the Commerce Clause is to curb state tax schemes that hinder interstate commerce. *E.g.*, *West Lynn*, 512 U.S. at 193 n.9 (explaining that James Madison considered the dormant aspect of the Commerce Clause more important and wrote that the Commerce Clause "grew out of the abuse of the power by the importing States in taxing the non-importing, and was intended as a negative and preventive provision against injustice among the States themselves") (citation omitted). The Court has uniformly held that discriminatory state tax schemes are essentially *per se* invalid under the dormant Commerce Clause and that rule applies here.

1. Kentucky's tax scheme facially discriminates against interstate commerce.

To determine whether a law violates the dormant Commerce Clause, "we first ask whether it discriminates on its face against interstate commerce." *United Haulers*, 127 S. Ct. at 1793. A law does so if it expressly distinguishes between in-state and out-of-state interests. *Camps*, 520 U.S. at 581 (state law affording more favorable tax treatment to

camps that served mostly in-state residents "facially discriminates against interstate commerce"). Facially discriminatory state laws are subject to the "virtually *per se* rule of invalidity," *Granholm*, 544 U.S. at 476 (internal quotation marks and citation omitted), and "the strictest scrutiny," *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979).

"All objects of interstate trade merit Commerce Clause protection," *Philadelphia v. New Jersey*, 437 U.S. 617, 622 (1978), and "[i]t is well settled that actions are within the domain of the Commerce Clause if they burden interstate commerce or impede its free flow," *Carbone*, 511 U.S. at 389 (citation omitted). The dormant Commerce Clause clearly applies to laws that discriminate against interstate investment activity, *id.* at 392 ("Discrimination against interstate commerce in favor of local business *or investment* is *per se* invalid, save in a narrow class of cases in which the municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest.") (citation omitted; emphasis supplied), including tax schemes that encourage in-state investment activity—*e.g.*, the purchase and sale of securities—at the expense of out-of-state activity, *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977) (State's higher tax on securities sales made on out-of-state exchanges placed "a discriminatory burden on commerce to its sister States").

Municipal bonds, including those issued by Kentucky, are independently rated commodities traded widely in the national municipal bond market. As the court below determined, Kentucky's tax scheme "obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. A6. The scheme thus facially discriminates against interstate transactions in out-of-state bonds and is unconstitutional. *Carbone*, 511 U.S. at 390 ("We have interpreted the Commerce Clause to

invalidate local laws that impose commercial barriers or discriminate against an article of commerce by reason of its origin or destination out of State."). Numerous precedents compel this conclusion.

In *Boston Stock Exchange*, regional stock exchanges challenged a New York statute that taxed securities sales on out-of-state exchanges at a higher rate than it taxed sales made on a New York exchange. 429 U.S. at 319. This differential treatment prevented investors from choosing "an exchange on the basis of services, prices, and other market conditions rather than geographical proximity." *Id.* at 333. It "foreclose[d] tax-neutral decisions and create[d] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister States." *Id.* at 331. Under the tax, "the flow of securities sales is diverted from the most economically efficient channels and directed to New York." *Id.* at 336. The Court reasoned that while "absent an undue burden on interstate commerce, the Commerce Clause does not prohibit the States from taxing the transfer of property *within* the State, the tax may not discriminate between transactions on the basis of some *interstate* element." *Id.* at 332 n.12 (emphasis supplied). The Court invalidated the tax, concluding that its "diversion of interstate commerce and *diminution of free competition in securities sales* are wholly inconsistent with the free trade purpose of the Commerce Clause," and that New York could not use its power to tax an intrastate event to require "other business operations to be performed in the home State." *Id.* at 336 (internal quotations omitted). So too here. Just as the tax in *Boston Stock Exchange* discouraged investors from choosing an exchange based on "services, prices, and other market conditions," *id.* at 333, Kentucky's tax scheme discourages Kentucky citizens from purchasing municipal bonds based on credit ratings, prices, and other market conditions, and encourages the pur-

chase of Kentucky bonds based solely on the availability of a tax exemption.[2]

In *New Energy Co. v. Limbach*, the Court unanimously struck down an Ohio statute designed to increase in-state production of ethanol by providing a tax credit to fuel dealers who sold ethanol produced in-state. Explaining that the statute was facially discriminatory because it "explicitly deprives certain products of generally available beneficial tax treatment because they are made in certain other States," 486 U.S. at 274, the Court concluded that the tax scheme "impose[d] an economic disadvantage upon out-of-state sellers" and violated the prohibition on laws "designed to give its residents an advantage in the marketplace . . . in connection with the State's regulation of interstate commerce," *id.* at 275-78. The same reasoning applies here.

In *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), the Court struck down a tax exemption for certain locally produced alcoholic beverages that encouraged the purchase of in-state beverages and discouraged the purchase of out-of-state beverages. The Court held that the exemption "violated the Commerce Clause because it had both the purpose and effect of discriminating in favor of local products." *Id.* at 273. While "a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry. . . . the Commerce Clause stands as a limitation on the means by which a State can constitutionally seek

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[2] Kentucky attempts to distinguish *Boston Stock Exchange*, stating that "the disparate treatment was between different types of out-of-state transactions, rather than in-state versus out-of-state transactions." Pet. Br. 28 n.16. But *Boston Stock Exchange* clearly involved disparate treatment between in-state and out-of-state transactions. 429 U.S. at 318 ("transactions involving an out-of-state sale [were] taxed more heavily than most transactions involving a sale within the State").

to achieve that goal." *Id.* at 271. So too here, "the Commerce Clause limits the manner in which States may legitimately compete for interstate trade." *Id.* at 272.

In *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the Court unanimously struck down an intangible property tax that applied to corporate stock owned by North Carolina residents and that varied inversely with a corporation's presence in the State (and thus its exposure to state income taxation). The tax foreclosed tax-neutral decisions, as North Carolina taxpayers who invested in corporations with more significant North Carolina operations had a lesser tax burden than those who invested in corporations with significant out-of-state operations. The Court held the tax to be unconstitutional because it facially discriminated against interstate commerce by, *inter alia*, favoring in-state corporations over out-of-state competitors in raising capital among North Carolina residents. 516 U.S. at 333. Here, as in *Fulton*, out-of-state and in-state entities compete for sales of securities within an interstate market. In-state municipal bonds that fund economic activity within the State are no more "unique" than in-state corporate stock, and the parallel is particularly exact as to Kentucky's industrial-revenue municipal bonds that fund private business activities. As the Court held in *Fulton*, there is no justification for allowing a State to retreat into economic isolation and hoard capital from its residents in contravention of the dormant Commerce Clause. *Id.*. at 330-31, 344.

In *Camps Newfound/Owatanna, Inc. v. Town of Harrison*, the Court struck down a Maine property tax exemption for charitable institutions limited to those that principally served Maine residents. The Court found it "[un]necessary to look beyond the text of [the] statute to determine that it discriminates against interstate commerce" as the exemption disparately treated similarly situated institutions based on whether they served in-state or out-of-state campers. 520 U.S. at 575-

76. Its holding reaffirmed the core principle that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Id.* at 581 (internal quotation omitted). Kentucky's tax scheme falls squarely within the Court's holding in *Camps*, as it penalizes Kentucky residents by increasing their tax burden for engaging in out-of-state commercial activity.

Kentucky's municipal bonds are plainly articles of interstate commerce—they are independently rated securities that are traded routinely among sellers and buyers "from all parts of the Nation." 520 U.S. at 573. They are commodities of interstate trade no less than the securities at issue in *Boston Stock Exchange* and *Fulton*, or the articles of commerce at issue in *Bacchus* and *Limbach*. Under an unbroken line of authority, Kentucky's tax scheme facially discriminates against interstate commerce and is unconstitutional.

2. Kentucky's tax scheme is unconstitutional even if the discrimination is not facial.

"The commerce clause forbids discrimination whether forthright or ingenious." *Best & Co. v. Maxwell*, 311 U.S. 454, 455 (1940). A determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose or discriminatory effect." *Bacchus*, 468 U.S. at 270 (internal citations omitted); *see Carbone*, 511 U.S. at 389-92, 394. "In each case it is our duty to determine whether the statute under attack . . . will in its practical operation work discrimination against interstate commerce." *Best*, 311 U.S at 455-56; *see West Lynn*, 512 U.S. at 201 ("Our Commerce Clause jurisprudence is not so rigid as to be controlled by the form by which a State erects barriers to commerce. Rather our cases have eschewed formalism for a sensitive, case-by-case analysis of purposes and effects."). Even if the Court were to conclude that Kentucky's tax scheme is not facially discriminatory, it is discriminatory nonetheless,

and unconstitutional under the rigorous scrutiny required by the Court's precedents.

a. Kentucky's discriminatory tax scheme is an unconstitutional burden equivalent to a tariff.

In *West Lynn*, the Court stated that "[t]he paradigmatic example of a law discriminating against interstate commerce is the protective tariff or customs duty, which taxes goods imported from other States, but does not tax similar products produced in State." 512 U.S. at 193. As the Court explained, "[a] tariff is an attractive measure because it simultaneously raises revenue and benefits local producers by burdening their out-of-state competitors," but tariffs "are so patently unconstitutional that our cases reveal not a single attempt by any State to enact one"; and thus "the cases are filled with state laws that aspire to reap some of the benefits of tariffs by other means." *Id.* Although Kentucky does not impose a tariff *per se* on out-of-state municipal bonds, its law has the same effect by taxing interest on out-of-state municipal bonds, while imposing no tax on in-state municipal bonds, thus reaping the benefits of a tariff "by other means." The scheme is unconstitutional.

As explained in *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511 (1935), laws that have the effect of "establishing an economic barrier against competition with the products of another state" essentially "set up what is equivalent to a rampart of customs duties." 294 U.S. at 527. Noting in *West Lynn* that the regulation at issue in *Baldwin* was invalid because it "had the same effect as a tariff or customs duty—neutralizing the advantage possessed by lower cost out-of-state producers," the Court held that the milk pricing order at issue in *West Lynn* was unconstitutional under *Baldwin*, *Bacchus*, and other precedents because it effectively imposed a tax that "[l]ike an ordinary tariff, . . . is thus effectively imposed only

on out-of-state products." *West Lynn*, 512 U.S. at 195. The same conclusion is warranted here.

b. Kentucky's discriminatory tax scheme is motivated by simple economic protectionism.

Facially neutral laws that are "motivated by simple economic protectionism are subject to a virtually *per se* rule of invalidity." *United Haulers*, 127 S. Ct. at 1793 (internal quotation marks and citation omitted); *Carbone*, 511 U.S. at 392; *Bacchus*, 468 U.S. at 272. In considering whether a law is motivated by simple economic protectionism, the analysis is not limited to legislative ends: If the means employed to achieve a legislative goal are themselves discriminatory, the legislation is subject to strict scrutiny regardless of whether its goal is non-protectionist or otherwise legitimate. *E.g.*, *Philadelphia*, 437 U.S. at 626-627 ("[T]he evil of protectionism can reside in legislative means as well as legislative ends," such that "whatever [the State's] purpose, it may not be accomplished by discriminating against articles of commerce coming from outside the State unless there is some reason, apart from their origin, to treat them differently.").

Kentucky seeks to avoid the consequences that flow from the reality that its tax scheme is motivated by simple economic protectionism by claiming that its scheme is justifiable as a revenue-generating measure. Kentucky does not argue the point openly because, as the Court has stated, "[b]y itself . . . revenue generation is not a local interest that can justify discrimination against interstate commerce." *Carbone*, 511 U.S. at 393. Instead, Kentucky baldly asserts that economic protectionism does not arise in "the provision of public works by sovereign States to their respective citizens." Pet. Br. 28. But again, the question is not whether Kentucky has the authority to issue bonds to raise funds for public purposes, but whether Kentucky may impose a discriminatory tax on out-of-state municipal bonds that impedes their sale in interstate

commerce. Whether economic protectionism arises when Kentucky issues a bond is irrelevant. It clearly arises as a result of Kentucky's distinct tax scheme.

Kentucky also contends that "[t]he evils of 'economic protectionism' are not manifested when the only 'in-state economic interest' is the taxing State itself. . . . There are no 'out-of-state competitors.'" Pet. Br. 28. The central fallacy of this argument is obvious: Kentucky is not the only one with an economic interest at stake, and its tax scheme clearly impacts out-of-state competitors; namely out-of-state issuers and sellers of municipal bonds that would otherwise compete on an equal basis for investment dollars in Kentucky. The intended purpose of Kentucky's scheme is to encourage the purchase of in-state municipal bonds by discouraging the purchase of out-of-state municipal bonds, and, thus, protect in-state economic interests at the expense of out-of-state economic interests. Indeed, Kentucky admits as much. Pet. Br. 12, 16. Accordingly, the scheme is unconstitutional.

3. Kentucky's law discriminates between similar financial commodities traded in the same market.

Kentucky argues that its scheme does not discriminate against interstate commerce on the theory that (1) its municipal bonds are not substantially similar to municipal bonds issued by other States because they differ with respect to use of proceeds and source of repayment, and (2) Kentucky is not substantially similar to any other bond issuer because no other issuer has the political responsibility for financing Kentucky projects. Pet. Br. 15, 17. This theory is meritless and Kentucky's reliance on *United Haulers* and *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997), is misplaced.

Tracy involved a comparison of different entities serving two distinct and longstanding natural gas markets established with congressional approval—a non-captive market for private gas marketers that supplied "unbundled" gas, and a dis-

tinct, highly regulated captive market that supplied "bundled" gas. The Court explained that "when the allegedly competing entities provide different products, . . . there is a threshold question whether the companies are indeed similarly situated for constitutional purposes," and that "[t]his is so for the simple reason that the different entities . . . serve different *markets* and would continue to do so even in if the supposedly discriminatory burden were removed." 519 U.S. at 299 (emphasis supplied). Stating that the "dormant Commerce Clause protects markets and participants in markets," *id.* at 300, the Court assessed whether similar products were traded in the same market by considering the similarity of the products and entities allegedly in competition, the existence of a single, competitive market, the makeup of intended purchasers, and whether competition would be enhanced by eliminating the discrimination, *id.* at 299-304.

Kentucky's theory that its municipal bonds are "unique" fails under this analysis. Applying *Tracy*'s *market-based* criteria, Kentucky plainly *is* substantially similar to other bond-issuing States because it performs all the same general functions as other governmental issuers and competes with other States for capital in the same national municipal bond market. Moreover, Kentucky municipal bonds and those issued by other States are virtually identical investment commodities traded in the same national municipal bond market. They are subject to the same federal securities laws and are structured to qualify for the same federal income tax exemption regardless of their state of origin; they are rated by the same rating agencies and purchased by the same underwriters; they are sold to the same investors and compete for the same capital; and competition would be enhanced by elimination of the discrimination. Indeed, the only reason Kentucky enacted its discriminatory tax scheme is because the municipal bonds of

all States are common financial commodities, and Kentucky sought to *create* a distinction through its discriminatory tax.

Similarly, although some municipal bonds are owned by funds that hold only the bonds of one State, this is so solely because of the discriminatory tax laws such as the one at issue here. J. Hellerstein & W. Hellerstein, STATE TAXATION 4-110, ¶ 4.13[2][e] (3d ed. 1998) ("If ever one needed proof that such discriminatory state taxes Balkanize our national capital markets, one need look no further than the state-specific municipal bond funds that have arisen directly as a result of these discriminatory state taxes."). And the fact that the discriminatory laws themselves create a distinction or local practice of this kind cannot justify them. *West Lynn*, 512 U.S. at 205 ("If we were to accept these arguments, we would make a virtue of the vice that the rule against discrimination condemns. Preserving local industry by protecting it from the rigors of interstate competition is the hallmark of the economic protectionism that the Commerce Clause prohibits."). The only relevant difference between Kentucky municipal bonds and those of other States is that they originate from different places, *the* classic example of an impermissible basis for discrimination. *E.g.*, *Camps*, 520 U.S. at 583 n.16.

As the Court's precedents make plain, the proper analysis considers the impact of Kentucky's scheme on the municipal bond market and its participants as a whole, *West Lynn*, 512 U.S. at 202, not what Kentucky does with the proceeds of its bonds or whether Kentucky's tax scheme serves a public purpose. *Oregon Waste* 511 U.S. at 100 ("[T]he purpose of, or justification for, a law has no bearing on whether it is facially discriminatory."). As the Court explained in *Tracy*, the dormant Commerce Clause aims to protect the integrity of an *actual* market as defined by ordinary commercial considerations, 519 U.S. at 299-300, not the artificial factors that Kentucky proposes to escape scrutiny. Such factors as "use of

proceeds," "source of repayment," and "responsibility for funding public projects" have nothing to do with defining the municipal bond market as it exists in the real world or the impact of Kentucky's tax scheme. Nor should these factors have a role in the analysis. To protect the integrity of a free market (the aim of the Commerce Clause), the Court should examine the impact of Kentucky's scheme on the market itself, including other issuers and sellers across the market. Kentucky's proposed factors are irrelevant to that analysis.

Kentucky contends that its tax scheme is not discriminatory "because it treats all *issuers* other than Kentucky itself—public, private, in-state, out-of-state—exactly the same." Pet. Br. 21 (emphasis supplied). But this statement truncates the analysis in a way that renders it essentially meaningless. First, it improperly excludes Kentucky (and, by extension, its tax scheme). In comparison to Kentucky, other out-of-state issuers of municipal bonds (*i.e.*, other States and their subdivisions) encounter a barrier owing to Kentucky's tax law that Kentucky does not face (*i.e.*, an impediment to access to private investment dollars in Kentucky). Second, Kentucky's law has a greater impact on the market than its effects on issuers. For example, it affects other private sellers of out-of-state municipal bonds who also encounter a barrier to access to Kentucky investors. Again, the relevant analysis focuses on the impact of Kentucky's tax law on the breadth of the municipal bond market as a whole, including all of its participants. *West Lynn*, 512 U.S. at 202-03 (rejecting State's argument that "since the Massachusetts milk dealers who pay the order premiums are not competitors of the Massachusetts farmers, the pricing order imposes no discriminatory burden on commerce"; noting that "[f]or over 150 years, our cases have rightly concluded that the imposition of a differential burden on any part of the stream of commerce-from wholesaler to retailer to consumer-is invalid, because a burden

placed at any point will result in a disadvantage to the out-of-state producer") (citing, *inter alia*, *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 444, 448 (1827)).

It is also irrelevant if *some* in-state sellers of municipal bonds in Kentucky share the burden of Kentucky's discriminatory tax scheme with out-of-state sellers; for example, in-state sellers of out-of-state municipal bonds. *E.g.*, *Carbone*, 511 U.S. at 391 (ordinance "is no less discriminatory because in-state or in-town processors are also covered by the prohibition"); *Bacchus*, 468 U.S. at 271 ("the effect of the exemption is clearly discriminatory, in that it applies only to locally produced beverages even though it does not apply to all such products"); *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 354 n.4 (1951) ("It is immaterial that Wisconsin milk from outside the Madison area is subjected to the same proscription as that moving in interstate commerce."). What matters is that out-of-state participants are disadvantaged and interstate commerce is impaired.

Kentucky's reliance on *United Haulers* also is misplaced. *United Haulers* provides no support for Kentucky's attempt to engraft onto dormant Commerce Clause analysis consideration of such factors as "use of proceeds," "source of repayment," and "responsibility for funding public projects." *United Haulers* also involved very different circumstances. There, the Court found that an in-state *public* trash facility was not substantially similar to any in-state or out-of-state *private* trash facilities and, therefore, an ordinance that favored use of the public facility was not discriminatory. In contrast, the discrimination here involves the disparate treatment of municipal bonds issued by similarly situated *public* entities (States) and traded by similarly situated *private* sellers and investors (underwriters, mutual funds, and other individual and corporate investors), all participating in the same *private* national market. The ordinance at issue in *United*

Haulers discriminated in favor of a local *public* business and against *all private* businesses, irrespective of whether they were located in-state or out-of-state. Here, Kentucky's tax scheme discriminates in favor of one public issuer against other public issuers and in favor of private ownership of in-state bonds against private ownership of out-of-state bonds. It thus bears *all* the hallmarks of a proscribed tariff designed to keep out commodities issued by other States and sold by out-of-state sellers in private interstate commerce.

4. Kentucky does not and cannot show that it has no other means to advance a legitimate purpose behind its discriminatory tax scheme.

To save a law that discriminates against out-of-state interests in interstate commerce, the State bears the burden of showing that it "has no other means to advance a legitimate local purpose." *United Haulers*, 127 S. Ct. at 1793. "[T]his is an extremely difficult burden, so heavy that facial discrimination by itself may be a fatal defect." *Oregon Waste*, 511 U.S. at 101 (1994) (internal quotation marks and citations omitted). Kentucky does not attempt to meet its burden and has thus waived its opportunity to do so. *Camps*, 520 U.S. at 582 ("[P]erhaps realizing the weight of its burden, the Town has made no effort to defend the statute under the per se rule, and so we do not address this question."); *Fulton*, 516 U.S. at 333-34. Kentucky simply states that its discriminatory tax scheme enables it to generate revenues. Again, revenue-generation is not a sufficient basis to justify discrimination against interstate commerce. *United Haulers*, 127 S. Ct. at 1798. If the law were otherwise, virtually every discriminatory tax scheme would be permissible because all tax schemes are designed to generate revenue. *Cf. Carbone*, 511 U.S. at 393-94 ("Otherwise States could impose discriminatory taxes against solid waste originating outside the State.").

B. Kentucky's Discriminatory Tax Scheme Violates The Purposes Of The Dormant Commerce Clause.

1. Kentucky's tax scheme fosters economic balkanization and retaliation.

A key goal of the Commerce Clause was the creation of a "unitary national market," *West Lynn*, 512 U.S. at 193, characterized by "free access to every market in the Nation," *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949), and "an area of free trade among the several States," *Boston Stock Exchange*, 429 U.S. at 328 (internal quotation marks and citation omitted). Kentucky's tax scheme frustrates this goal by creating a barrier to the sale of out-of-state municipal bonds in Kentucky. Out-of-state issuers and sellers of municipal bonds should be free to sell out-of-state bonds to Kentucky citizens, and Kentucky citizens should not be penalized for engaging in interstate commerce by purchasing out-of-state municipal bonds. *Id.* at 335 ("This free trade purpose is not confined to the freedom to trade with only one State; it is a freedom to trade with any State, to engage in commerce across all state boundaries.").

One recognized benefit of free trade is the avoidance of ongoing, low-level "trade wars" that emerge when States are forced to retaliate against their neighbors' discriminatory, protectionist laws. *Granholm*, 544 U.S. at 473; *Carbone*, 511 U.S. at 390 ("The central rationale for the rule against discrimination is to prohibit state or municipal laws whose object is local economic protectionism, laws that would excite those jealousies and retaliatory measures the Constitution was designed to prevent."). Kentucky's scheme, combined with the similar laws of other States, has precisely the effect of fostering an ongoing, low level trade war, and is a textbook example of a law the Commerce Clause was intended to prevent. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-80 (1995) (explaining that the Commerce

Clause contains "a contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject" and that this command "serve[s] the Commerce Clause's purpose of preventing a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear").

Utah's similar tax law vividly illustrates the retaliatory nature of the discriminatory tax scheme challenged here. Utah does not tax income earned from in-state or out-of-state municipal bonds, *unless* the out-of-state bond was issued by a State that imposes a tax on income from Utah bonds. Utah Code Ann. § 59-10-114(6)(a) (2007).[3] Obviously, Utah's tax retaliates against other States that tax the income from Utah's municipal bonds, but not their own.

Kentucky argues that the "free market rationale is attenuated here," as the "sovereign States are not farmers or craftsmen attempting to provide goods and services to the citizens of their sister States," and that a consumer of public goods provided and financed by Kentucky can never "'look to . . . free competition' from other States to provide education,

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[3] While Utah was considering whether to implement a tax on out-of-state bonds, a Salt Lake City newspaper quoted the Assistant Majority Whip in the Utah House of Representatives as saying, "As I see it, what's the basis for Utah to encourage investment in other states? If you live in Michigan or Minnesota there is no incentive to buy muni bonds outside your state. But in Utah there is a disincentive to buy local bonds. In order to make Utah bonds more attractive, you have to provide a greater rate of return or provide a more secure investment. But if both bonds have a AAA rating, the only way to make the Utah bond competitive is to pay a higher interest rate." Max Knudson, *Veto of "Muni" Bill Urged*, DESERET NEWS, March 12, 2001, at B08.

roads, sewers, prisons, and bridges for Kentucky." Pet. Br. 27-28. But the relevant commodity is not any public infrastructure or service, but municipal bonds that are bought, sold, and traded in interstate commerce. Again, Kentucky confuses its power to borrow money from private investors by issuing bonds to finance public services with its authority to tax bonds traded in interstate commerce. Kentucky's tax scheme discriminates against out-of-state municipal bonds, and what Kentucky does with the bond proceeds is irrelevant.

2. Kentucky's discriminatory tax scheme hoards private capital and impedes interstate commerce.

The Court has long recognized that the Commerce Clause proscribes the hoarding of local resources to the detriment of a cohesive and equitable market economy. *Baldwin v. Fish & Game Comm'n*, 436 U.S. 371, 385-86 (1978); *West v. Kansas Natural Gas Co.*, 221 U.S. 229, 255 (1911). Kentucky's tax scheme is intended to, and has the effect of, hoarding available private investor capital in Kentucky and impeding the free flow of capital in interstate commerce. Kentucky's scheme thus violates this purpose of the Commerce Clause and is unconstitutional. *Fulton*, 516 U.S. at 343 (rejecting States' creation of preferential trade areas as constitutionally impermissible); *Dean Milk*, 340 U.S. at 356 (striking down discriminatory ordinance, stating that it "would invite a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause," and concluding that, under the circumstances, "the regulation must yield to the principle that 'one state in its dealings with another may not place itself in a position of economic isolation'") (quoting *G.A.F. Seelig, Inc.*, 294 U.S. at 527).

3. Kentucky's tax scheme is undemocratic.

A key concern of the Court's dormant Commerce Clause jurisprudence is the avoidance of discriminatory tax laws that place the burden of the discrimination on those who cannot

vote out of office those who have imposed it. *United Haulers*, 127 S. Ct. at 1797. This concern is rooted in the ancient principle of no taxation without representation. *E.g.*, THE DECLARATION OF INDEPENDENCE para. 19 (U.S. 1776). In granting Congress the power to regulate interstate commerce, the Framers clearly intended to deny the States the power to impair interstate commerce with tariff-like taxation that burdened those who could not protest: "A very material object of this power was the relief of the States which import and export through other states from the improper contributions levied on them by the latter." THE FEDERALIST NO. 42, at 235-36 (J. Madison). Kentucky's discriminatory tax scheme plainly burdens out-of-state issuers (who have no recourse but to retaliate with discriminatory taxes of their own) and out-of-state sellers (who have no ability, through exercise of the franchise, to protest the burden placed upon them). As such, it is profoundly undemocratic and unconstitutional.

C. Kentucky's Discriminatory Tax Scheme Imposes Additional Harms Antithetical To A Free Market.

Kentucky's discriminatory tax scheme imposes a number of other harms, chief among them the harm of permitting a participant in the national municipal bond market to distort that market and create inefficiencies. Among other distortions, discriminatory tax schemes like the one at issue here have fostered the growth of funds that hold only the municipal bonds of a single state. As compared to national tax-exempt bonds funds, these tend to be higher risk and higher cost. Joel Michael, *Department of Revenue of Kentucky v. Davis: Implications for State Tax Policy and Dormant Commerce Clause Doctrine*, 45 STATE TAX NOTES (forthcoming 2007) (as compared to single-state bond funds, national tax-exempt funds are geographically diversified and have lower costs). Single-state funds are higher risk because they undermine the cardinal diversification principle, and tend to be

higher cost because of the loss of economies of scale. Discriminatory tax laws thus foster comparatively risky, expensive investment vehicles.

Kentucky's tax scheme also harms its own interests. Kentucky contends that its scheme boosts revenues by reducing borrowing costs (*i.e.*, the interest it pays on its bonds). It reasons that, by not taxing the income its citizens earn on Kentucky bonds, it can pay a below-market interest rate and still attract Kentucky investors who benefit from the bonds' tax-exempt status. Pet. Br. 24; NAST Am. Br. 29; SIMFA Am. Br. 7. But as Kentucky concedes, it also loses the tax revenue it would otherwise earn if it its bonds were not tax-exempt. Pet. Br. 23. And it is a documented phenomenon that the loss of revenue in all likelihood more than offsets the lower interest payments. Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds be Justified? Thoughts on the Davis Topside Briefs*, 117 TAX NOTES (forthcoming October 2007). Indeed, studies indicate that the tax exemption *costs* States significant money. C. Steven Cole *et al.*, *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, J. FIN. & STRATEGIC DECISIONS, Summer 1994 at 72-73, 75; Mary E. Loverly & Michael J. Wasylenko, *State Taxation of Interest Income and Municipal Borrowing Costs*, 45 NAT. TAX J. 37, 48-51 (1992).[4] Because States appear to lose more revenue via discriminatory tax exemptions than they gain by borrowing at

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[4] The Cole study of 1985-1987 found that "the cost to the states in the form of lost tax revenues is significantly greater than the estimated benefit of reduced interest costs to in-state issuers." Cole at 73. Loverly & Wasylenko estimate that in the first year of repayment on a hypothetical Kentucky bond, *the revenue lost due to the tax exemption was nearly double the amount of the revenue saved by borrowing at the lowered interest rate*. Loverly at 50.

lower rates, it is unlikely that revenue-raising is the true motivation behind these schemes. Instead, these tax schemes are protectionist measures enacted in an ongoing retaliatory trade war. The States would all be better off if *none* of them had discriminatory tax laws, but so long as *one* State has enacted such a law, others are compelled to follow.

If just one State enacts a discriminatory tax law like Kentucky's, and the others treat all bonds as tax-exempt, the one State that discriminates benefits *both* from selling its bonds freely in the national interstate municipal bond market while at the same time blocking other States' access to its residents. The result is a classic "race to the bottom." Where all States have the same discriminatory law, the playing field is relatively equalized, but the States suffer collectively a net harm because the loss of revenue from offering a tax exemption to their residents more than offsets the lower interest payments that they pay on their bonds. The cure here is to remove the discrimination by enforcing the dormant Commerce Clause.

D. Kentucky's Taxation Scheme Cannot Be Sustained On Any Theory Of Publicly Owned Business.

Kentucky's contention that *United Haulers* "is controlling here," Pet. Br. 21, is wrong. *United Haulers* involved very different circumstances and a fundamentally different analysis. *United Haulers* involved a state-owned local *business* established in response to public demand to alleviate pressing social problems. 127 S. Ct. at 1791 (noting health, safety, and racketeering problems). This case involves a state *tax* scheme designed to generate revenue for Kentucky that applies to private property traded in a national private market that Kentucky does not own. The distinction between a State's use of its police power to remedy a perceived problem involving local health and safety (the issue in *United Haulers*), and its power to regulate interstate commerce through a discriminatory tax (the issue here) is constitutionally signifi-

cant and analytically distinct. *E.g.*, *West Lynn*, 512 U.S. at 206 n.21 ("This distinction between the power of the State to shelter its people from menaces to their health or safety and from fraud, even when those dangers emanate from interstate commerce, and its lack of power to retard, burden or constrict the flow of such commerce for their economic advantage, is one deeply rooted in both our history and our law.") (quoting *Hood*, 336 U.S. at 533). Moreover, the question presented here—whether a State may use its *tax* power to restrict interstate commerce by discriminating against the issuance, purchase, and sale of out-of-state municipal bonds in the national market—was not at issue in *United Haulers*. Further, *United Haulers* did not involve a facially discriminatory tax scheme; this case does. Here, the Court's dormant Commerce Clause precedents in the tax context apply in full force, and these decisions clearly require the conclusion that a State may *not* use its tax power in the manner at issue in this case.

This case also differs from *United Haulers* with respect to political accountability concerns. In *United Haulers*, the Court stated that "the most palpable harm imposed by the ordinances—more expensive trash removal—is likely to fall upon the very people who voted for the laws." 127 S. Ct. at 1797. Not so here. The States with which Kentucky competes for capital in the national municipal bond market have no voice in the Kentucky legislature; nor do other sellers of municipal bonds from other States who wish to sell them to Kentucky citizens. Yet, these out-of-state interests suffer the most palpable harm from Kentucky's tax scheme, exacerbated because almost all States have retaliated against each other by enacting similar discriminatory laws, thus distorting and impairing the market from multiple source points.

Kentucky contends that this case presents no political accountability issue on the theory that the taxpayers who must pay the tax on interest from out-of-state municipal bonds are

represented in the Kentucky legislature. Not so. To begin with, the Court has explicitly rejected this argument:

> This argument, if accepted, would undermine almost every discriminatory tax case. State taxes are ordinarily paid by in-state businesses and consumers, yet if they discriminate against out-of-state products, they are unconstitutional. The idea that a discriminatory tax does not interfere with interstate commerce "merely because the burden of the tax was borne by consumers" in the taxing State was thoroughly repudiated in [*Bacchus*]. The cost of a tariff is also borne primarily by local consumers, yet a tariff is the paradigmatic Commerce Clause violation. . . . .

West Lynn, 512 U.S. at 203-04 (internal citations omitted). The Court concluded in *West Lynn* that "[t]he obvious impact of the order [challenged in that case] on out-of-state production demonstrates that it is simply wrong to assume that the pricing order burdens only Massachusetts consumers and dealers." *Id.* The same is true in this case.

Further, the "most palpable harm" here cannot be said to fall on Kentucky taxpayers who pay a tax on interest from out-of-state municipal bonds. The tax scheme itself is designed to reduce the number of such taxpayers, and these taxpayers are unlikely to complain because they can avoid the tax by purchasing in-state bonds. Here, out-of-state issuers and sellers bear the most palpable harm, and they have no voice in the Kentucky legislature.

Nor do out-of-state issuers and sellers have any other surrogate in Kentucky. In *United Haulers*, the interests of in-state private businesses were largely aligned with those of out-of-state private businesses (*e.g.*, they shared the same cost concerns related to tipping fees). 127 S. Ct. at 1797. Thus, local businesses could serve as a surrogate for out-of-state private businesses adversely affected by the ordinances

and could use established political channels to advocate for legislative change. *Id.* On those facts, the Court stated that there was "no reason to step in and hand local businesses a victory they could not obtain through the political process." *Id.* The opposite is true here. No local *public* business in Kentucky competes with the Commonwealth in the municipal bond market. And *private* bond issuers have no incentive to complain about Kentucky's scheme because they do not compete with Kentucky in the tax-exempt municipal bond market either.[5] Thus, in contrast to *United Haulers*, there is no "powerful safeguard against legislative abuse," and the burdens created by Kentucky's scheme are "unlikely to be alleviated by the operation of political restraints normally exerted when interests within the state are affected." 127 S. Ct. at 1797; *see West Lynn*, 512 U.S. at 200-01 & n.17. In this case, Kentucky's law creates a nearly perfect externality by placing its most palpable costs outside its borders.

Kentucky's argument that its tax scheme cannot be unconstitutional because its purpose is to benefit itself, Pet. Br. 32, also has no basis is law or logic. Once again, Kentucky errs by focusing on its status and authority as a bond-issuer and provider of public services to Kentucky citizens. But the

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[5] That interest on both in-state and out-of-state private bonds is taxed under Kentucky's scheme is of no moment. Interest on out-of-state municipal bonds is exempt from federal taxation. The same is not true of private bonds. Private bond issuers do not compete with the States in the market at issue here (the tax-exempt municipal bond market) and to the extent that private bond issuers may be said to be disadvantaged by the existence of tax-exemptions for municipal bonds, that disadvantage exists in any event by virtue of the federal tax exemption, which also is much larger than the exemption provided by Kentucky's scheme. Yale & Galle, 115 TAX NOTES at 1043 ("[T]he municipal bond market is sufficiently distinct from the taxable bond market that competition between municipal and taxable bonds is not constitutionally significant.").

question is not whether Kentucky may invoke its police power to issue and repay municipal bonds for some public purpose. Under the Court's discriminatory tax precedents, the analysis focuses on the impact of Kentucky's discriminatory tax scheme on the interstate municipal bond market and its other participants. Nothing in *United Haulers* changes this analysis in cases, such as this one, involving a facially discriminatory tax that functions as a tariff.

Moreover, *every* tax, and every tax exemption or incentive, is intended to favor the State that imposes it. If accepted, Kentucky's argument would justify every kind of discriminatory tax, including tariffs. Further, Kentucky's local interest argument ignores the fact that its discriminatory tax impairs the ability of its sister States to provide goods and services to their citizens by manipulating the national municipal bond market. Kentucky's law cannot be considered in a vacuum, and its impact must be taken into account. The circumstances of this case were not present in *United Haulers*, and Kentucky cannot rely on either *United Haulers* or any principle of local interest to justify its law.

Respondents in *United Haulers* urged an "approach of treating public and private entities the same." 127 S. Ct. at 1797. Respondents here seek only to ensure that financial commodities issued by similarly situated public entities and traded in the private bond market are taxed or not taxed equally. The disparate-impact analysis of *United Haulers* does not apply to Kentucky's facially discriminatory tax scheme. A judgment affirming the decision below will not lead to "unprecedented and unbounded interference by the courts," *id.*, as such a judgment falls well within the boundaries of the Court's precedents and is necessary to preserve the integrity of the municipal bond market.

E. The Market Participant Doctrine Does Not Apply, And Kentucky's Subsidy Analogy Is Misplaced.

The Court has recognized that a State acting as if it were a private party in the market may exercise "the long recognized right of trader or manufacturer, engaged in an entirely private business, freely to exercise [its] own independent discretion as to parties with whom [it] will deal." *Reeves, Inc. v. Stake*, 447 U.S. 429, 438-39 (1980) (internal quotation marks and citation omitted). Consistent with this rationale, the Court has confined the market participation doctrine to situations in which a State participates in the market on the same terms as a private party and has held that the doctrine does *not* apply where, as here, a State imposes conditions only a state actor could impose. The Court has concluded that a State acts as a market participant only when "burdened with the same restrictions imposed on private market participants," *id.* at 438, and specifically held that the doctrine cannot validate a tax exemption because "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine," *Camps*, 520 U.S. at 593.

Kentucky argues that the Court should disregard this limitation on the theory that it could have encouraged the purchase of its bonds some other way (such as through a subsidy) and, thus, it makes no difference that it encourages the purchase of its bonds through a tax scheme. The Court has rejected this argument, and has explicitly held that a State cannot justify a discriminatory tax on the theory that it could have accomplished the same purpose with a subsidy. *Limbach*, 486 U.S. at 277 ("The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description in connection with the State's regulation of interstate commerce. Direct subsidization of domestic industry does not

ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does.").

This is a tax case, and the Court's precedents direct that Kentucky's use of its tax power to discriminate against out-of-state bonds is constitutionally significant and is evaluated under the constitutional rules applicable to exercise of the tax power. That Kentucky might have encouraged the purchase of its municipal bonds in some other way (*e.g.*, through a subsidy or by restricting the sale of its bonds to its residents) that might be evaluated under other constitutional rules is irrelevant and does not justify application of the market participant doctrine. In *Limbach*, for example, the Court rejected Ohio's argument that the market participant doctrine applied because its facially discriminatory tax scheme was like a subsidy. The Court reasoned that "[t]he Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes—a primeval governmental activity." 486 U.S. at 277. While the scheme had "the purpose and effect of subsidizing a particular [in-state] industry," it imposed a tax penalty on the favored industry's competitors in transactions in which Ohio was not involved, treatment that "cannot plausibly be analogized to the activity of a private purchaser." *Id.* at 278. The Court thus held unanimously that "[t]he market-participant doctrine has no application here." *Id.*

In *Camps*, the Court rejected Maine's invocation of the market participant doctrine for the same reason. Maine provided local tax relief to children's summer camps that served primarily in-state residents, but not to camps that served primarily out-of-state individuals. Maine argued that its tax scheme was, in effect, a way to buy services for its residents. Although the Court was divided on the ultimate result in the case, no justice suggested that the market participant doctrine applied. *See* 520 U.S. at 607 (Scalia, J., dissenting). As in

Limbach, Maine's scheme may have had "the purpose and effect of subsidizing" camps that provided services to Maine resident children, but it did so by penalizing camps that provided services to other children, even though Maine did not contend that it engaged in transactions with those disfavored camps. "The activity of a private purchaser" could not have imposed a similar penalty. A private charity certainly could give money to camps serving Maine children (and so could Maine) but a private charity with no connection to the transaction could not send a bill to camps serving out-of-state children, which is what Maine and its municipal entities actually did. The Court thus rejected the notion that "whenever a State provides a discriminatory tax abatement it is 'purchasing' some service in its proprietary capacity." *Id.* at 594.

Kentucky's assertion that it is "just" using its tax power to fix the terms of its bonds, Pet. Br. 42, 44-45, also is unavailing. First, Kentucky accomplishes its goal, not by altering the terms of its own bonds, but by taxing other States' bonds. The Court's precedents reject Kentucky's theory and focus the analysis on the impact of its tax scheme. Second, Kentucky is no more "just" fixing the terms of its bonds than Alaska was "just" determining the terms of the sale of state-owned timber by requiring that all such timber be processed in Alaska. *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 96-99 (1984) (plurality). That a State issues or originates a commodity does not mean that the State is free to restrict interstate commerce by impairing the subsequent private trade of that commodity, *id.* at 96, let alone the same commodity issued by others.

A State's use of its tax power implicates all the restrictions incident to that power, and allowing the market participant doctrine to shield discrimination through taxation "would swallow the rule against discriminatory tax schemes." *Camps*, 520 U.S. at 594. As in *Limbach*, the Kentucky action

"ultimately at issue is neither its purchase nor its sale of [its own bonds], but its assessment and computation of taxes [on other bonds]—a primeval governmental activity." 486 U.S. at 277. The scheme is neither a subsidy nor any other market activity that a private party could perform. The market participant doctrine, and its underlying principles, do not apply.

F. Kentucky's Reliance On *Bonaparte* And Principles Of Sovereignty Are Misplaced.

Kentucky errs in arguing that *Bonaparte v. Tax Court*, 104 U.S. (14 Otto) 592 (1881), requires reversal. *Bonaparte* holds that a State may tax income generated by property (securities) owned by a resident taxpayer even though the property originated from another State and would be taxed differently (*i.e.*, not at all) if the taxpayer resided elsewhere. The case did not decide the very different question presented here: whether the same State may tax differently income generated by property (securities) of a resident taxpayer based on whether the property originated in- or out-of-state.

In *Bonaparte*, a Maryland resident claimed an exemption for interest earned on state and municipal "stocks" issued outside of Maryland on the basis that they were of "public character" and were exempt from taxation by the laws of their issuing States. 104 U.S. at 592. The applicable Maryland tax statute did not, however, exempt interest income on publicly issued debt, whether issued in Maryland or a sister State. Brief for Plaintiff in Error 1-4 ("Pl. Br.") (quoting the Maryland tax statute). Upon Maryland's denial of the claimed exemption, the plaintiff sued, challenging the denial. 104 U.S. at 592. The trial court upheld her challenge, but the appellate court reversed, and the plaintiff appealed to this Court, alleging a violation of the Full Faith and Credit Clause. *Id.* The Court upheld the tax, reasoning that, even though a citizen of a State may invest in debt issued by other

States, the citizen is still "a resident of the State in which he dwells" and subject to its tax power. *Id.* at 595.

The question presented in this case could not possibly have been before the Court in *Bonaparte* because Maryland did not then have a discriminatory tax scheme similar to Kentucky's. The Maryland statute assessed taxes on, *inter alia*, "all shares of stock . . . owned by residents of this State," "all bonds made by . . . any other State," and "all property of every kind, nature and description within this State," except for an exclusive list of property exempt from the tax. Pl. Br. at 2. Notably absent from the list were *any* publicly issued debt instruments, including any issued within Maryland. *Id.* Thus, under the statute, public bonds issued by Maryland *and* its sister States were equally taxable. Moreover, nothing in the record suggests that the plaintiff sought, received, or was entitled to an exemption for interest on any Maryland bond. *Id.* at 1-6; Brief of Charles J.M. Gwinn, Attorney General of Maryland, for the Defendant in Error at 1-6.

That *Bonaparte* neither considered nor analyzed the dormant Commerce Clause is reinforced by the Court's subsequent treatment of the case. Despite Kentucky's claim that *Bonaparte*'s "sweeping declaration . . . frame[s] this dormant Commerce Clause case," Pet. Br. 14, the Court has not once referred to *Bonaparte* in the context of a dormant Commerce Clause challenge. Moreover, to the extent *Bonaparte* is applicable here, it undermines Kentucky's position. The Court observed that, when a State seeks to borrow funds, "it is compelled to go into the market as a borrower subject to the same disabilities in this particular as individuals." 104 U.S. at 595. Kentucky does *not* seek to "go into the market" with "the same disabilities" as a private party, but rather armed with its coercive tax power to discourage the purchase of out-of-state municipal bonds.

Kentucky's "sovereignty" arguments fare no better. Relying on *Bonaparte*, *Georgia v. Chattanooga*, 264 U.S. 472 (1994), and *Nevada v. Hall*, 440 U.S. 410 (1979), Kentucky argues that an "essential attribute" of state sovereignty is "the mutual exclusivity of the sovereignty of the States vis-à-vis each other." Pet. Br. 31. But these cases concern extraterritorial application of state laws, a point not at issue here.[6] The question before the Court is not whether Kentucky may tax interest income derived from the municipal bonds of other States, but whether Kentucky may tax income earned on other States' bonds while simultaneously exempting income earned on its own bonds. Also inapposite are the "federalism cases" Kentucky relies on, each of which involves issues that are irrelevant to the question presented here. *E.g.*, *Federal Maritime Comm'n v. South Carolina State Ports Auth.*, 535 U.S. 743, 751-52 (2002) (concerning whether a State's sovereign immunity bars a federal agency from adjudicating private suits against States; holding that it did, as "[a]n integral component of [the] 'residuary and inviolable sovereignty' retained by the States is their immunity from private suits")

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[6] *Georgia*, 264 U.S. at 480 ("Land acquired by one state in another state is held subject to the laws of the latter and to all the incidents of private ownership."); *Nevada*, 440 U.S. at 426-27 ("In this Nation, each sovereign governs only with the consent of the governed. . . if a federal court were to hold . . . that California is not free in this case to enforce its policy [despite Nevada's non-conforming policy], that holding would constitute the real intrusion on the sovereignty of the States. . . in our Union."); *Bonaparte*, 104 U.S. at 594 ("No State can legislate except with reference to its own jurisdiction."). *The Schooner Exchange v. McFadden*, 11 U.S. 116 (1812), did not consider the sovereignty of a State in relation to other States, but the sovereignty of the Nation in relation to other nations, and held that our Nation's absolute autonomy and territorial jurisdiction must yield to that of another nation only where necessary to promote mutual trade intercourse. 11 U.S. at 136-38.

(internal quotations omitted); *Printz v. United States*, 521 U.S. 898, 919-22 (1997) (discussing separation of federal and state powers, and the inability of the federal government to impose obligations on state offices to carry out federal laws because of the "double security" afforded by federalism); *Garcia v. San Antonio Metropolitan Transit Auth.*, 469 U.S. 528, 553-55 (1985) (addressing the ability of *Congress* to enforce, via the Commerce Clause, a *federal* statute against a State; holding enforcement constitutional because federalism is safeguarded through the *national* political process).

Kentucky's tax scheme violates the dormant Commerce Clause. It cannot be saved on the basis of the sovereignty, extraterritoriality, and federalism cases cited by Kentucky in its defense. *See Nevada*, 440 U.S. at 425 ("While sovereign nations are free to levy discriminatory taxes on the goods of other nations or to bar their entry altogether, the *States of the Union are not*. . . . [O]urs is not a union of 50 wholly independent sovereigns.") (emphasis supplied).

G. Kentucky's Scheme Fails Under *Pike*.

If the Court were to determine that Kentucky's tax scheme is non-discriminatory, that would not end the matter. The law then would be analyzed under *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970), holding that a nondiscriminatory statute will be upheld "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefit." 397 U.S. at 142. The lower courts did not conduct the relevant analysis, which involves questions of fact, and Kentucky does not address the issue here.[7] To the

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[7] Although some of Kentucky's *amici* contend that Kentucky enjoys benefits from the relevant tax scheme that outweigh its burdens, they offer no evidence to support their argument, only bald assertions of benefit, unaccompanied by any real analysis of burden. *E.g.*, GFOA. Br. 23.

extent the Court addresses any aspect of the *Pike* test, the tax scheme plainly fails the test. As discussed, the scheme burdens excessively interstate commerce, is counter-productive, and the only reason Kentucky enacted it is that other States have done so. Alternatively, if the Court were to determine that Kentucky's tax scheme is non-discriminatory, the Court should remand for consideration of the *Pike* analysis.

H. None Of The Other Arguments Made By Kentucky And Its *Amici* Require Reversal.

1. Congressional inaction does not provide a basis for reversal.

Kentucky and its *amici* argue that congressional inaction constitutes congressional approval of the discriminatory bond taxation schemes enacted by most States. The argument is meritless. As one *amicus* brief admits, "this Court is generally reluctant to draw inferences from congressional silence." GFOA Br. 4. Moreover, congressional inaction provides no basis for the Court to refrain from judicial intervention, particularly where, as here, the "constitutional . . . mandate for judicial choice is clear." *Tracy*, 519 U.S. at 309.

Kentucky asserts that Congress has had occasion to prohibit discriminatory taxation of out-of-state municipal bonds and did nothing. It points to a 1959 congressional act that commissioned a study of general tax matters having an impact on business activities in interstate commerce, and suggests that the resulting report, and summary of statutes included therein, demonstrates congressional acceptance of discriminatory municipal bond tax schemes. Pet. Br. 37-39. Kentucky ignores that the act authorizing the study shows that Congress was focused on businesses facing tax obligations in various States, not discriminatory taxes on municipal bonds. It also misrepresents and exaggerates the 1964 report of the Special Subcommittee on State Taxation of Interstate Commerce (the "Subcommittee"). The Subcommittee stud-

ied the tax areas "with which Congress was mainly concerned in authorizing the project: Income taxes and sales and use taxes as they apply to businesses selling goods in interstate commerce." H.R. REP. NO. 88-1480, vol. 1, at 14 (1964). It explicitly excluded personal income taxes from its analysis, as well as income taxes of other entities that might be impacted by the discriminatory tax schemes at issue here. H.R. REP. NO. 89-952, vol. 4, Part VI, at 1163 (1965) ("The specific proposals set forth in this chapter do not apply to . . . financial institutions, investment companies, and holding companies. Nor do they apply to income taxes imposed on individuals or unincorporated businesses."). These studies and reports do not demonstrate congressional acquiescence, let alone the kind of congressional approval necessary to save Kentucky's discriminatory scheme.

2. The fact that refunds may be warranted does not provide a basis for reversal.

Kentucky argues that a decision of this Court that affirms the decision below and applies retroactively would pose a hardship because taxpayers would demand refunds. States routinely make such arguments and the Court routinely rejects them.[8] Where a State's tax policies "violate[] constitu-

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[8] In *South Carolina v. Baker*, 485 U.S. 505 (1988), the Court upheld a federal tax on interest from certain state-issued bonds, despite South Carolina's arguments, similar to Kentucky's arguments here, that upholding the federal tax statute "would force South Carolina to pay approximately 3% to 5% more by way of interest rates." *South Carolina v. Baker*, Compl., Ex. B., ¶ 9 (Feb. 7, 1983) (Aff. of Grady L. Patterson). South Carolina argued that if the Court upheld the statute, thus requiring States to issue registered bonds or forego the federal tax exemption, it could not "withstand without severe hardship the potential loss of money under either alternative. The fact that all fifty States will also be immediately economically burdened to a significant extent . . . compounds the urgency." Pl. Mot. For Leave to File Compl. and Supporting Br. 40-41.

tional norms well established under existing precedent," the burden a State faces in providing relief for those violations is "largely irrelevant." *American Trucking Ass'ns, Inc. v. Smith*, 496 U.S. 167, 183 (1990). In *Harper v. Virginia Dep't of Tax'n*, 509 U.S. 86 (1993), over 40 States signed an *amicus* brief urging the Court to affirm the decision of the court below, in part, because a reversal order that applied retroactively would burden the public fisc. The Court declined. 509 U.S. at 95 n.9 ("Federal law applicable to a particular case does not turn on 'whether [litigants] actually relied on [an] old rule [or] how they would suffer from retroactive application' of a new one."). Clearly, Kentucky's interest in avoiding paying refunds "does not justify a refusal to provide relief." *McKesson Corp v. Division of Alcoholic Bevs. & Tobacco*, 496 U.S. 18, 50 (1990). Any potential hardship that a State may face in providing tax refunds does not excuse the State from its obligation to "provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *Harper*, 509 U.S. at 101 (internal quotation omitted); *see Reich v. Collins*, 513 U.S. 106, 114 (1994).

3. Kentucky's parade of economic horribles is overblown and does not provide a basis for reversal.

Kentucky and its *amici* claim that affirmance would cause financial problems in the market. *E.g.* Pet. Br. 36; Churchill Br. 18-19; Dupree Br. 6-7; GFOA Br. 8-10. One Kentucky *amicus*, however, states on its website that an affirmance would have relatively little effect, which is a far more accurate assessment.[9] As the statement indicates, although an af-

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[9] Churchill Tax-Free Fund of Ky., Prospectus Supp. & Statement of Additional Information, April 30, 2007, supplemented June 1, 2007, *available at http://www.aquilafunds.com/Download/CHURCHILL%20TAX-FREE%20A&C.pdf*

firmance may have some small effect on the price of some bonds, the market will adjust quickly. Affirmance will not cause any State to default on its bonds, will not cause the municipal bond market to collapse, and will not require any State to forego repairing its roads or building its schools. It will simply put an end to Kentucky's discriminatory, inefficient, and counter-productive tax scheme. Absent discrimination, investment diversification will be easier. Likewise, smaller States that lack the same access to capital as New York or California will likely have an *easier* time finding purchasers for their bonds. James F. Blumstein, *Some Intersections of the Negative Commerce Clause and the New Federalism: The Case of Discriminatory State Income Tax Treatment of Out-of-State Tax-Exempt Bonds*, 31 VAND. L. REV. 473, 546 (April 1978) ("Absent discrimination, relatively capital-scarce states, whose bonds might be more attractive when viewed from a 'tax-neutral' perspective, could more easily compete for capital funds concentrated in large commercial areas.") (citation omitted). States that exempt from taxation interest on their own bonds may simply raise interest rates to offset the loss of the exemption. Robert Zipf, HOW MUNICIPAL BONDS WORK 75 (1989). This could actually lead to increased net revenue. Municipal bonds would still be attractive investments because of the federal tax exemption, which is almost always much larger than the state exemption. And changes in federal tax laws altering marginal rates and related bond values historically have had a far greater market impact than the elimination of the protectionist tax schemes implicated here, without any of the dire consequences Kentucky and its *amici* predict. Kentucky objects to changing the status quo because it reflects a widespread practice. But asking the Court to disregard a constitutional violation because it is widespread is perverse. None of Kentucky's arguments justify what it seeks.

4. The States have long been aware that their discriminatory municipal bond taxation schemes are potentially unconstitutional and Kentucky's reliance argument provides no basis for reversal.

Kentucky argues that "substantial reliance interests" counsel in favor of reversing the decision below. Pet. Br. 35. Kentucky offers no support for this assertion and it provides no ground for reversal in any event. States have long been aware of the problem. Commentators pointed it out decades ago, *see* Blumstein, 31 VAND. L. REV. 473 (identifying the problem thirty years ago), and State legislatures have actually considered the matter. For example, in March 1995, Minnesota Representative Rest submitted an amendment to Minnesota's tax statute, Minn. Stat. Ann. § 290.01, proposing to repeal the individual income tax exemption for municipal bond interest on in-state bonds. Representative Rest testified at a hearing that the rationale for the repeal was to "reduce the State's exposure to future losses under lawsuits that will be challenging in-state bond exemptions." Municipal Bond Taxation Hrg. on H.F. 1380 Before the Sales and Income Tax Division of the Committee on Taxes, 1995 Leg., 79th Sess. 6 (Mn. 1995) (statement of Rep. Ann Rest, Member, House Comm. on Taxes).[10] The Minnesota Commissioner of Finance also cautioned the legislature: "[T]his is a continuing tax code issue that will be with us whether it surfaces [now or in the future] . . . it is poor planning on our part to not recognize that a similar liability potential [tax refunds] is out there

[10] Tapes of committee meetings are available from the Minnesota Historical Society Library. Respondents will provide the cited tapes to the Court upon request.

on this issue." *Id.* (statement of Laura King, Comm'r of Finance, House Comm. on Taxes).[11]

More importantly, given the obviously discriminatory nature of its tax scheme and its obvious impact on interstate commerce, Kentucky's reliance argument rings hollow, as did Florida's argument in *McKesson* that its "reliance on a presumptively valid statute" was a "relevant consideration" in determining whether an "obligation to provide relief for its unconstitutional deprivation of property" exists. 496 U.S. at 46 (internal quotation omitted). The *McKesson* Court concluded that Florida could "hardly claim surprise" at the state court's invalidation of its taxation scheme, as the Court had invalidated a "virtually identical" scheme in *Bacchus*. *Id.*

I. Alternatively, Kentucky's Taxation Scheme Violates The Import-Export Clause.

Article I, § 10, cl. 2, of the Constitution provides that "[n]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws." Kentucky's discriminatory tax scheme violates this prohibition. The historical record shows that the Import-Export Clause extends to articles traded in commerce among the States as well as to those shipped to and from foreign nations. *Camps*, 520 U.S. at 609-40 (Thomas, J., dissenting); *Almy v. California*, 65 U.S. (24 How.) 169, 175 (1860) (overturning under Import-Export Clause a stamp tax on bills of

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[11] Utah has also considered the problem. When the legislature enacted its discriminatory tax scheme, the Office of Legislative Review and General Counsel observed that the "differential taxation of interest on debts might be challenged as discriminatory under the Commerce Clause of the Constitution of the United States." RSA 29a; *see* Leg. Rev. Note attached to H.B. 1006, 2001 Leg., 1st Spec. Sess. (Ut. 2001), *available at* http://www.le.state.ut.us/~2001S1/ bills/hbillamd/HB1006.pdf.

lading for gold shipped from California to New York). This interpretation is supported by THE FEDERALIST, which viewed as an unconstitutional evil not only tariffs that a State might impose on foreign trade, but duties that a State might impose on goods shipped through one State from other States. THE FEDERALIST NO. 42, at 235-36 (J. Madison) ("A very material object of this power was the relief of the States which import and export through other states from the improper contributions levied on them by the latter."). It is also supported by the fact that the clause creates an exception for inspection laws, which would have applied to goods shipped from one State to another as well as to goods shipped abroad.

The Import-Export Clause is one of four interrelated clauses that collectively and explicitly create a national trade zone free of domestic duties imposed by any State, and free of several types of duties that Congress might impose that could discriminate against the commercial interests of one State over another. Article I, § 8, cl. 1 gives Congress the power to lay uniform taxes, duties, imposts, and excises nationwide, but requires that they be "uniform." In turn, the Import-Export Clause explicitly removes from the States the authority to levy duties on imports and exports (except as necessary for inspection purposes). Article I, § 9, cl. 5 removes from Congress the authority to levy duties on exports abroad from any State, but leaves untouched Congress's power to tax imports from abroad. Finally, Article I, § 9, cl. 6 explicitly forbids Congress from levying duties that favor the ports of one State over those of another, and also mandates that ships going to and from domestic ports shall not be obliged to pay duties in these ports: "nor shall Vessels bound to, or from, one State, be obliged to enter, clear, or pay Duties in another." As used in the Import-Export Clause, the terms "import" and "export" refer to articles traded in interstate commerce, not just those traded abroad. Although the

term "impost" (also used in the clause) likely refers to a duty assessed shipside on goods imported from abroad, *see Camps*, 520 U.S. at 637-38 (Thomas, J., dissenting), the phrase "duties on imports or exports" did not bear such a limited connotation but would commonly have been understood to apply to taxes levied on goods or written instruments shipped in interstate commerce. *Id.* at 638-39. This interpretation makes particular sense because, if "duties on imports" meant only duties on *foreign* items, the reference to "imposts" would be redundant.

For these reasons, and as explained more thoroughly by Justice Thomas in his dissent in *Camps*, the determination of *Woodruff v. Parham*, 75 U.S. (8 Wall.) 123 (1868), that the Import-Export Clause applies only to foreign commerce is unsound, and the clause prohibits Kentucky from levying a duty on out-of-state municipal bonds. This does not prevent Kentucky from taxing the income its residents earn from municipal bonds but simply prohibits Kentucky from discriminating against out-of-state bonds through its tax scheme. That the scheme discriminates by exempting Kentucky's municipal bonds from taxation while taxing out-of-state municipal bonds, rather than by a direct duty or tariff, is of no moment. *West Lynn*, 512 U.S. at 210-11 (Scalia, J., concurring) (tax exemption only for in-state commodity is no different from discriminatory tax imposed only and directly on out-of-state commodity). Kentucky's tax scheme is a discriminatory duty proscribed by the Import-Export Clause and the Court should affirm the decision below on this alternative basis.

CONCLUSION

For the foregoing reasons, the Court should affirm the decision of the Kentucky Court of Appeals in this case.

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